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Reforming The Alternative Minimum Tax System.

In a special report, Stewart S. Karlinsky describes how to reform the alternative minimum tax system.

===== SUMMARY =====

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The following article is an abstract from a longer article to be published in the American Journal of Tax Policy in the Spring of 1995.

===== FULL TEXT =====

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The American Tax Policy Institute held a roundtable discussion in Washington on July 15, 1994, on how to reform the alternative minimum tax (AMT) system for corporate and individual taxpayers. The topic is particularly relevant with the recent House Republican proposals to repeal the AMT in the beginning of the next century and to emasculate it now.

The American Tax Policy Institute is a nonpartisan, nonprofit organization interested in promoting tax simplification, good tax policy, and tax laws that minimize economic distortions. With these goals in mind, the institute convened a meeting of tax experts from the private sector (attorneys and accountants), government (IRS, Treasury, CEA, GAO, and Congress), nonprofit sector (Citizens for Tax Justice and Urban Institute), and academia (law, business, and economics) to discuss the individual and corporate AMT systems. Given the wide range of backgrounds, talents, and viewpoints of those present, a remarkable consensus /1/ was reached that the current AMT system is not meeting its original intended policy goals, is very complex, its administrability by taxpayers and the government is less than adequate, and this parallel tax system needs to be drastically overhauled or repealed.

I. Legislative Background

A. Individual

The primary genesis of the 1969 individual add-on minimum tax was a speech by then secretary of the Treasury Joseph Barr disclosing that in 1966 there were 154 individual taxpayers with adjusted gross incomes (AGI) above \$200,000 who paid no federal income tax. This caught the imagination and attention of the public and Congress. In a voluntary tax system like ours, perceived abuses are of obvious concern because of their potential impact on compliance.

A more objective view held by tax scholars at that time was that the law included tax preferences that were intended to encourage certain activities or behaviors. If these special rules were exploited to an extreme, some mechanism was needed to limit their availability. The enacted governor to control the perceived abuses was, and still is, the minimum tax.

The appropriate 1969 congressional committees discussed several alternative approaches to correct the perceived abuses, including: limiting the tax preferences by not allowing the hypothetical tax liability before preferences to be reduced by more than one-half; and the enacted Senate version, an add-on minimum tax that aggregated certain tax preferences, subtracted the regular income tax, and taxed the difference at a 10-percent rate. This amount was added to the regular individual tax liability.

Interestingly, in the 1990s we have over 600 taxpayers who have adjusted gross incomes above \$200,000 who pay no tax. As a matter of fact, there are over 100

individual taxpayers with AGIs over \$500,000 that still pay no tax. In all fairness, there were more than 270,000 individual taxpayers who were subject to AMT in 1992 and they paid over \$1 billion in tax. These numbers do not include taxpayers that were required to compute the AMT but whose regular tax was higher, or where the AMT served as a floor, below which the minimum tax credits may not be utilized.

It also should be noted that the nonpaying taxpayer statistics do not reflect individuals who may be paying some tax, but are not paying what may be perceived as their fair share. For example, a taxpayer might have income of \$500,000 and pay a tax of only \$5,000 (1-percent tax rate). This taxpayer would not be included in either the 1966 or 1992 statistics of nonpayers. Many of these taxpayers are caught in the AMT net.

Another important but unresolved issue is whether AGI is the appropriate measure of whether people are paying their fair share of tax. For example, tax-exempt income as well as inheritances and gifts are excluded, as are incentive stock options (ISOs) and some lump sum pension distributions. Certain negative adjustments such as net operating loss carryovers artificially understate AGI, and items like investment interest expense and moving expenses probably should be reflected in whatever measurement standard is used.

B. Corporate

The current corporate AMT system can be traced to more recent events, but ironically, also to similar press releases citing nonpayment of taxes. In the mid-1980s, Citizens for Tax Justice publicized a study that found over 100 corporations that reported large financial statement income and paid no federal income tax. Congress reacted to these charges by passing the book untaxed reported profits (BURP) provisions of section 56 for 1987-89. The BURP adjustment essentially compared book income and adjusted taxable income, and increased the latter by one-half of the difference. In a political compromise between Sen. Bob Packwood, R-Ore., and Rep. Dan Rostenkowski, D-Ill., the BURP system was replaced with the current adjusted current earnings (ACE) parallel world provisions for tax years beginning after 1989. In 1992, a net \$2.4 billion was raised in the corporate AMT, \$4.8 billion owed and \$2.4 billion MTC offsetting regular tax.

II. Problems with the Current AMT System

In the all-day deliberations of the ATPI conference as well as in a half-day planning meeting, it was amply evident to all participants that the AMT system is broken, and needs to be thoroughly overhauled or repealed. Criticism of the complexity engendered by

the parallel system, problems with administration, horizontal inequities, and too many unresolved issues all were cited as being unacceptable. Ironically, even the enactment of this highly complex sub-tax system did not resolve Secretary Barr's and CTJ's concern that we have wealthy people or profitable corporations not paying any federal income tax.

III. Agenda for Change

A. Tax Policy Issues

There were five alternative solutions suggested for correcting current AMT problems. Much of the discussion focused on properly stating the tax policy goals that the AMT system was enacted to address.

Some of the participants thought that the primary policy reason was that every taxpayer that has earned economic income in a tax period should pay some minimum amount of tax, even though past years' losses or credits might zero it out for regular tax. It should be noted that the regular tax system could be modified to accomplish this without engendering the complexity of a parallel AMT system.

Another group noted that the regular tax system provides incentives to behave in a certain way, but if a taxpayer takes "too much advantage" of these provisions, or in combination with other incentives is paying little or no regular tax, then the AMT is appropriate for that taxpayer. An add-on minimum tax also might be designed to accomplish this policy goal.

A segment of the attendees thought that the underlying problem that the AMT was designed to counter was the "leverage" issue (e.g., interest on debt is deductible and depreciation is available on the total asset cost, including the debt portion). Since an indexing system is politically unpalatable to counter this advantage, the AMT was designed to correct the problem. Also, since much of the interest income is earned by tax-exempt organizations, there is a large revenue drain that the AMT system helps offset. Some participants argued that a limit on business interest expense might be a more direct and less cumbersome solution.

An alternative view was that there should be horizontal tax equity regardless of whether a person is doing business as a C corporation or as an S corporation, LLC, partnership, or sole proprietorship. This group was strongly in favor of repealing the ACE by collapsing it into the AMT system.

There was some extended discussion by the IRS and practitioners on the relevance of complexity engendered

by the parallel system. The IRS representatives observed that with computer programs the importance of complexity as a policy issue should be diminished. The practitioners noted that the application of the parallel system, the impact of various state and local tax regimes, the need to produce the numbers for the computers to crunch, consolidated return complexity, section 56(g)(4)(G), and different interpretations among tax preparers and computer systems still make complexity a significant tax policy issue both as to compliance and administrative costs.

In retrospect, much of the universal frustration with the AMT system might be attributed to the fact that people do all this work and spend all this time trying to comply, and what they get for this considerable effort is paying a little more tax today rather than tomorrow. In effect, it is not accomplishing the stated policy goals.

B. Alternatives

Participants' views of which goals were more important seemed to guide which of the following alternatives they favored.

1a. Repeal the corporate and individual AMT system and incorporate the desired provisions directly into the regular tax system. This might be made more politically attractive by reducing the regular tax rates, since a broader tax base will have been created. A sub-alternative to this was to make the depreciation life/method and its related adjusted basis computation for regular tax the same as for AMT, so that one major level of complexity is eliminated and many taxpayers no longer would be subject to the AMT system.

1b. A significant sub-group was in favor of repealing the individual AMT and including the desired provisions in the regular tax system, but modifying the current corporate AMT system by collapsing the ACE provisions directly into the AMT system. This collapsing could be done on a 75-percent or a 100-percent basis. Some heated discussions arose about which was more appropriate. Some argued that the change shouldn't be a tax increase, while others argued that it is difficult to justify why some items are a 75-percent preference and others are 100 percent.

Another debate ensued as to the appropriate treatment of the past year's positive ACE adjustment. The AICPA has suggested that the past year ACE be amortized over the near future, while others argued that this was unnecessary if the corporate taxpayer is subject to regular tax in the next few years. If it is not, then reversing the past year's positive adjustments would be fairer.

Although options 1a and 1b had the support of the majority of participants, the political realities are such that the AMT is a good back-door way to raise taxes without the general populace being aware of it. Because of the political realities, the group recommended some second-best alternatives.

2. Take the existing AMT system and modify it so that it is more administrable and less complicated. This would include:

a. Repeal section 56(g)(4)(G). This extremely complex and highly ignored provision has been up for repeal in two tax bills, but due to nonpolicy reasons, has not been repealed.

b. If a corporation is required to compute alternative minimum taxable income solely for purposes of section 59A (Superfund environmental tax), then modified regular taxable income should be used for section 59A purposes. This would eliminate a compliance nightmare for many small businesses with a de minimis loss of revenue.

c. The AMT standard exclusion might be modified in one of several ways: index it; increase it so that small business and many individuals will not be required to compute the AMT; decrease it and eliminate some current AMT preferences such as state income taxes and miscellaneous deductions.

d. Move nonresidential real estate depreciation useful life from 39 to 40 years for regular tax purposes. This will totally eliminate an AMT adjustment as well as the separate tracking of an AMT adjusted basis for newly acquired real estate.

e. Conform the individual MTC calculation to the current corporate calculation. All taxpayers should get either a full MTC carryforward or only that related to nonexclusion items. To have corporations, which as a general rule can handle complexity more easily than individuals, enjoy the benefit of a simpler regime that is unavailable to individuals is highly questionable policy.

f. Provide a small business exemption from ACE or AMT, such as prior three years' average gross receipts being less than \$5,000,000. Obviously, there will be some transition complexity engendered when a corporation moves from below to above this limit.

g. Per Alternative 1 above, collapse the ACE parallel system into the AMT and utilize one system of depreciation rather than two or three.

3. Go back to the pre-1986 add-on minimum tax system in which a separate tax is added to the regular tax when the sum of tax preferences exceed some statutory amount such as the regular tax liability. The problem with this alternative is that it was tried and found lacking. Serious modification to the old system would be needed to ensure that it had teeth and accomplished its goals. The advantage of this alternative is that it does not engender a parallel tax system as our current AMT system does.

4. Go back to the original 1969 tax proposal that was never enacted, in which there would be some limit on the amount of tax preferences allowed to a taxpayer in a given year. For example, tax preferences would be allowed, but not to the extent that they reduce taxes below 50 percent of the tax without preferences. The advantage of this alternative is that it is not a separate tax system. The disadvantage is identifying which preferences should be limited. Also, the definition of theoretical regular tax is essential. For example, how would tax-exempt bond interest income (private activity or regular) be handled in this system? How are NOL carryovers and credits handled under this regime?

IV. Conclusion

We hope that Congress, Treasury, and other policymakers will reexamine the policy reasons behind the AMT system and derive a simpler, fairer, and more compliance-oriented tax so that it minimizes economic distortions. At a minimum, the suggestions in Alternative 2 should be enacted relatively soon to make the current parallel system more palatable.

FOOTNOTE

/1/ While I refer to a consensus, no one conclusion advanced in this article enjoyed the support of all participants.

END OF FOOTNOTES

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